Vanguard economic and market update

KEY TAKEAWAYS:

- The threat of a recession is rising
- Trade tensions with China have reached an impasse
- The Federal Reserve will likely cut rates by 50 basis points in 2019
- Projected U.S. stock returns over the next ten years: 3.5%–5.5% range
- Projected U.S. bond returns over the next ten years: 2.0%–4.0% range

Recession watch

- Vanguard increased in June what we see as the likelihood of a U.S. recession in the next 12 to 18 months, from 30% to 40%, due in part to continuing trade tensions and an inverted yield curve.
- A global or major regional recession in the next 12 months isn’t our base case.

The Fed in focus

- Vanguard’s base case remains that the Fed will ease the federal funds rate by 50 basis points in 2019.
- Minutes of the Fed’s June meeting and Fed Chairman Jerome Powell’s testimony to Congress on July 10 and 11 reflect concerns that risks to the U.S. economic outlook had grown since the Fed’s previous meeting, stemming from uncertainties around trade and continued weakness in inflation.
- Meanwhile, we now expect the European Central Bank to cut rates by up to 20 basis points and restart quantitative easing, at a pace of about 30 billion euros a month, by year’s end.
- We expect the Bank of England to keep its bank rate at 0.75% for the next 12 months amid Brexit uncertainty.
- We similarly expect the Bank of Japan to keep policy rates on hold, though, as with the Bank of England, risks are skewed toward the next move being further easing rather than tightening.

The jobs outlook may weaken as the year progresses

- U.S. job creation was strong in June, with 224,000 nonfarm positions added. The service sector accounted for the vast majority of the jobs—the strongest showing for the sector since January.
- Vanguard expects the jobs number to fade back toward and even below 150,000 per month by year’s end.
Global growth will moderate in the second half of 2019

- Vanguard expects global growth to continue to soften over the next 12 months, owing to trade tensions, policy uncertainty, and the fading of fiscal stimulus in the United States and China.
- Vanguard cut on June 10 its outlook for U.S. economic growth, expecting it to slow to an annualized pace of 1.7% by year’s end, with full-year 2019 growth closer to our 2.0% forecast. Such a view considers U.S.-China trade tensions and uncertainty from other bilateral trade negotiations.
- Vanguard is slightly more bearish than consensus estimates on our view for growth in China, despite upside surprises on July 15 on three measures of economic activity. Vanguard maintains its call for 2019 GDP growth at a below-trend pace of about 6.2%, with risks on the downside, and growth by year’s end slowing to 6.0% or 6.1%.
- China needs to strike a balance between near-term growth and medium-term financial stability.
- Vanguard sees 2019 growth in the euro area of about 1.0% as the manufacturing sector stabilizes over the coming quarters.

A noticeable downward shift in the world’s largest economies

Sources: Vanguard calculations, using data from Thomson Reuters Datastream.
Trade issues continue in the spotlight

- Vanguard believes that, owing to intractable structural issues, the United States and China have likely reached an impasse on resolving trade difficulties.
- The result will likely be a permanent tariff regime that includes the existing 25% U.S. tariffs on $250 billion of Chinese imports and the imposition of 10% tariffs on roughly $300 billion of remaining Chinese imports.
- Some goods that can’t easily be sourced elsewhere—such as consumer electronics—will likely be excluded from tariffs.
- Meanwhile, France has voted to impose a 3% tax on large global tech companies, the first European Union member to do so after a broader E.U. effort stalled earlier in the year. This could lead to U.S. retaliation ahead of U.S.-E.U. trade negotiations.
- And the United States-Mexico-Canada Agreement will likely go before Congress in September. Vanguard sees a better than 50% chance of its passage at some point this year, with a much higher likelihood of ratification before the end of 2020. (Mexico has approved the deal.)

Asset class return outlooks

These 10-year return projections, based on market conditions as of March 31, 2019, are as follows:

<table>
<thead>
<tr>
<th>Equities</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>U.S. equities</td>
<td>3.5%–5.5%</td>
</tr>
<tr>
<td>Global equities ex-U.S. (unhedged)</td>
<td>6.5%–8.5%</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Bonds</th>
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<tbody>
<tr>
<td>U.S. bonds</td>
<td>2.0%–4.0%</td>
</tr>
<tr>
<td>U.S. Treasury bonds</td>
<td>1.5%–3.5%</td>
</tr>
<tr>
<td>U.S. credit bonds</td>
<td>2.5%–4.5%</td>
</tr>
<tr>
<td>Global bonds ex-U.S. (hedged)</td>
<td>1.5%–3.5%</td>
</tr>
</tbody>
</table>

These probabilistic return assumptions depend on current market conditions and, as such, may change over time.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of March 31, 2019.

Results from the model may vary with each use and over time.

Source: Vanguard Investment Strategy Group.
All investing is subject to risk, including possible loss of principal.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets.

**IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.**

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard’s primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.